Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:POSTF-148841-01
EYWu

date: MAR 2 0 2002

to: [redacted], Internal Group Manager, LMSB [redacted]
[redacted], International Examiner, LMSB [redacted]

from: June Y. Bass, Associate Area Counsel (LMSB)
Erica Y. Wu, Attorney (LMSB)

subject: Taxpayer: [redacted].
Tax Years: Forms 1120 - [redacted]
Forms 1042 -
Issue: I.R.C. §§ 1441, 1442 withholding
I.R.C. §§ 6651(a), 6656(a), and 6038A(d)(3) penalties

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to your request for our advice dated August 6, 2001. This memorandum should not be cited as precedent.

ISSUES

1. Whether interest should be imputed under I.R.C. § 482 on loans made to the Taxpayer from its foreign parent for the periods in which the interest was waived.

a. If so, what is the rate that should be used to impute the interest?

2. Whether an interest rate that is below the lower limit of the safe haven interest rates set forth in Treas. Reg. § 1.482-2(a)(2)(iii)(B) is considered below-market thereby entitling the Service to impute additional interest under I.R.C. § 482.

3. Whether the Taxpayer is liable for withholding taxes under I.R.C. §1442 on the interest imputed under I.R.C. § 482.

4. Whether the [redacted] debt-equity conversion constitutes a constructive payment of interest to the Taxpayer's foreign parent

thereby subjecting the Taxpayer to a withholding tax liability under I.R.C. §1442.

a. Whether the Taxpayer realized any cancellation of indebtedness ("COD") income as a result of the debt-equity conversion.

5. Whether the Taxpayer is liable for withholding taxes under I.R.C. §1442 on the interest and royalties that it deducted but did not actually pay.

6. Whether the Taxpayer's foreign parent may treat the rental income that it received from the Taxpayer as income which is effectively connected with a U.S. trade or business ("ECI") and file Forms 1120-F reporting that income.

7. Whether the Taxpayer is subject to the § 6656(a) penalty for failing to make withholding tax deposits during [redacted] through [redacted].

8. Whether the Taxpayer is subject to the § 6651(a) penalty for failing to file Forms 1042 for [redacted] through [redacted].

9. Whether the Taxpayer is subject to the § 6038A(d)(1) penalty for filing incomplete Forms 5472 for FYE [redacted] and FYE [redacted].

CONCLUSIONS

1. Yes. Interest should be imputed for the periods in which the interest was waived. The Taxpayer clearly had the ability to pay. An unrelated creditor dealing at arm's length with the Taxpayer would have expected interest payments during those periods.

a. The Service may impute interest at the stated of rate of 7%, provided this rate meets the arm's length standard under Treas. Reg. § 1.482-2(a)(2). If the stated rate does not meet the arm's length standard, then the Service may use the lower limit of the safe haven interest rates set forth in Treas. Reg. § 1.482-2(a)(2)(iii).

2. No. An interest rate does not become a below-market rate merely because it falls below the lower limit of the safe haven interest rates. If that rate is an arm's length rate under Treas. Reg. § 1.482-2(a)(2)(i), it will be respected and no I.R.C § 482 adjustment is required.

3. Yes. We take the position that I.R.C. § 482 adjustments may trigger I.R.C. § 1442 withholding.

4. Yes. In the Ninth Circuit, the forgiveness of debt in exchange for stock constitutes a payment of the debt. As such, a

portion of the payment should be treated as interest subject to withholding under I.R.C. § 1442.

a. We do not have sufficient facts to opine on whether the Taxpayer realized any COD income.

5. Yes. We see little problem holding the Taxpayer liable for withholding tax on the interest and royalties that it deducted.

6. Yes. The Taxpayer's foreign parent may treat the rental income as ECI under I.R.C. § 882(d)(1) and the applicable treaty. The parent may also file Forms 1120-F reporting the rental income. The parent, however, may claim the deductions and credits associated with the rental income only if the Forms 1120-F (including protective Forms 1120-F) are filed within the time limits set forth in Treas. Reg. § 1.882-4(a)(3)(i). If the parent does not file Forms 1120 reporting the rental income, the Taxpayer will be subject to a 30% withholding under I.R.C. § 1442 on that income.

7. and 8. For [redacted] and [redacted], we recommend that you inquire whether the Taxpayer has any reasonable cause to justify its failures to file Forms 1042 and to make withholding tax deposits. For [redacted] and [redacted], we recommend that you develop additional facts as to why the Service refunded the withholding tax deposits made by the Taxpayer during those years.

9. We recommend that you obtain additional facts to determine whether the Forms 5472 were "substantially incomplete," as that term is used in Treas. Reg. § 1.6038A-4(a)(1). We also recommend that you inquire as to why the Taxpayer omitted the transactions that should have been reported on the Forms 5472. You should evaluate the reasonableness of the Taxpayer's explanations before asserting the § 6038A(d)(1) penalty. Moreover, we note that I.R.C. § 6501(c)(8) may apply to FYE [redacted] and render this otherwise closed year open to adjustments. Please contact this office immediately if you wish to pursue the § 6501(c)(8) issue.

FACTS[1]

[redacted] Inc. ("[redacted]") is a U.S. corporation with its principal place of business in [redacted]. [redacted], [redacted], [redacted]. ("[redacted]") is an [redacted] corporation. [redacted] owns [redacted] of [redacted], which in turns owns [redacted] of [redacted] Corp. [redacted] ("[redacted]"), a [redacted] corporation.

[redacted] is in the business of designing, manufacturing, and distributing "[redacted]" brand of [redacted] wear, equipments, and accessories. [redacted] principal business activity is the distribution and sale of the "[redacted]" merchandise. [redacted] manufactures the majority of the goods sold by [redacted].

[redacted] uses the accrual method of accounting for both book and tax purposes. It uses the fiscal year ending June 30th as its tax year.

At all times relevant to this case, [redacted] activities in the United States did not amount to a permanent establishment within the meaning of [redacted] (the "Treaty").

Intercompany Payables and Receivables

During the tax years at issue, [redacted] financed [redacted] operation by providing cash and paying [redacted] expenses. [redacted] has consistently treated the financing as a loan and recorded each financing transaction in a payable account.[2]

During the tax years at issue, [redacted] also became indebted to [redacted]. Generally, the indebtedness arose when [redacted] (1) provided cash to [redacted] foreign subsidiaries,[3] (2) made payments to [redacted]

---

[1] Our understanding of the facts of this case is limited to the facts presented by you. We have not undertaken any independent investigation of the facts of this case. If the actual facts are different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

[2] The bona fides of the loans in this case is not at issue.

[3] [redacted] also owns [redacted]% of [redacted], an [redacted] corporation ("[redacted]"), and [redacted]% of [redacted], a [redacted] corporation ("[redacted]"). The nature of [redacted] and [redacted] business is

vendors, and (3) incurred expenses on behalf of [redacted]. [redacted] recorded the debt owed by [redacted] in a receivable account.

[redacted] never directly repaid the loans that it owed to [redacted] with cash. Instead, it repaid the loans by assigning the receivables to offset the payables. [redacted] employed an accounting system whereby the total payables and the total receivables were netted against each other on a monthly basis to produce a net monthly payable. The net monthly payables were then consolidated on an annual basis and reduced to an interest-bearing promissory note. [redacted] utilized an account called "Intercompany Loan Payable" (the "Loan Account") to perform the netting and to trace the cumulative balance of the net payables.

The following chart ("Chart A") summarizes the activities in the Loan Account from January [redacted] through December 31, [redacted].[4] "Total credits" represent the total payables incurred during the specified period. "Total debits" represent the total receivables incurred during the specified period.

Periods	Beginning Balance	Total credits	Total debits	Ending Balance (Cumulative Net Payables)
[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]

Debt-Equity Conversion

As Chart A shows, as of [redacted], there was a balance of $[redacted] in the Loan Account. On [redacted], [redacted] converted $[redacted] of that amount into [redacted] shares of preferred stock. The fair market value of the preferred stock at the time of the conversion is unknown.

Notes

Between FYE [redacted] and FYE [redacted], [redacted] executed the following notes (collectively the "Notes"):

---

unknown.

[4] Chart A was prepared using the data contained in the agent's work paper titled "Exhibit C-1."

Date of Note	Amount of Note	Interest Rate Per Annum
[redacted] ("Note 1")[5]	$[redacted]	[redacted]%
[redacted] ("Note 2")[6]	$[redacted]	[redacted]%
[redacted] ("Note 3")[7]	$[redacted]	[redacted]%
[redacted] ("Note 4")[8]	$[redacted]	[redacted]%
[redacted] ("Note 5")[9]	$[redacted]	[redacted]%

The terms of the Notes were substantially the same, as follows:

1. Interest shall be accrued and paid annually.

2. The principal and any accrued but unpaid interest shall be due [redacted] months from demand by [redacted].

3. [redacted] has the option to apply any repayments to interest first and then to principal.

Interest on the Notes

[redacted] accrued the interest on the Notes in an account titled "Accrued Int Payable-[redacted]." [redacted] books show that [redacted] waived the

---

[5] Note 1 represents the balance in the Loan Account immediately after the $ [redacted] debt-equity conversion. The amount of this note is calculated as:
$ [redacted] - $ [redacted] = $ [redacted].

[6] Note 2 represents the net increase in the Loan Account during the period from [redacted] through [redacted]. The amount of this note is calculated as:
$ [redacted] - $ [redacted] = $ [redacted].

[7] Note 3 represents the net increase in the Loan Account during FYE [redacted]. The amount of this note is calculated as:
$ [redacted] - $ [redacted] = $ [redacted].

[8] Note 4 represents the net increase in the Loan Account during FYE [redacted]. The amount of this note is calculated as:
$ [redacted] - $ [redacted] = $ [redacted].
The slight variation is due to rounding.

[9] Note 5 represents the net increase in the Loan Account during FYE [redacted]. The amount of this note is calculated as:
$ [redacted] - $ [redacted] = $ [redacted].

interest accrued in FYE [redacted][10] and [redacted], and $ [redacted] of the interest accrued in FYE [redacted]. [redacted] claims the waiver was due to its inability to pay.

[redacted] did not waive the interest accrued in FYE [redacted] and [redacted].

On the returns that it filed for FYE [redacted] through [redacted] claimed the following interest expenses relating to the Notes:

FYE [redacted]	$[redacted]
FYE [redacted]	$[redacted]
FYE [redacted]	$[redacted][11]
FYE [redacted]	$[redacted][12]
FYE [redacted]	$[redacted][13]

[redacted] never actually paid interest to [redacted].

Royalties

During the tax years at issue, [redacted] was obligated, pursuant to a licensing agreement, to pay [redacted] royalties for the use of [redacted] patents and trademarks. The royalties were to be calculated based on a percentage of [redacted] sales.

In FYE [redacted], [redacted] accrued $ [redacted] of royalties. In FYE [redacted], [redacted] accrued $ [redacted] of royalties. [redacted] deducted the corresponding amounts on its FYE [redacted] and FYE [redacted] returns.

---

[10] In your memorandum dated August 6, 2001, you stated that interest accrued in FYE [redacted] and [redacted] was waived. Since Note 1 was not executed until [redacted], your statement suggests, and we assume, that there were other notes pursuant to which interest was accrued during FYE [redacted]. You should obtain those notes.

[11] This amount is calculated as:
(Note 1 x [redacted]%) + (Note 2 x [redacted]%) - $ [redacted](waiver).

[12] This amount is calculated as:
(Note 1 x [redacted]%)+(Note 2 x [redacted]%)+(Note 3 x [redacted]%).

[13] This amount is calculated as:
(Note 1 x [redacted]%)+(Note 2 x [redacted]%)+(Note 3 x [redacted]%)+(Note4 x [redacted]%).

[redacted] never actually paid the royalties to [redacted]. The royalties accrued in FYE [redacted] and [redacted] were credited to the Loan Account.

Rents

During the tax years at issue, [redacted] leased an operating facility in [redacted] owned by [redacted]. Under the lease agreement between the parties, [redacted] was to receive a rental income of $ [redacted] per month. The fair market value of the rent is not at issue.

[redacted] never actually paid the rents to [redacted]. All the rents were credited to the Loan Account.

[redacted] deducted the rents accrued under the lease agreement for each year from FYE [redacted] through [redacted].

During the audit, [redacted] filed protective Forms 1120-F for FYE [redacted] and [redacted] for the purpose of securing its right to treat the rental income as ECI under I.R.C. § 882(d).

[redacted] Financial Condition

[redacted] U.S. Corporation Income Tax Returns, Forms 1120, for FYE [redacted] through FYE [redacted], show the following:

	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Gross Receipts (line 1c)	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Gross Profit (line 3)	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Total Income (line 11)	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Taxable Income before NOL (line 28)	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]

Schedules L, "Balance Sheets," attached to Forms 1120 show the following:

	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Cash	($[redacted])	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Total Assets	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Loans from Shareholders	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Total Liabilities	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]

As of June 30, [redacted], [redacted] had $ [redacted] of accumulated net operating losses which it carried forward to FYE [redacted], [redacted], [redacted], and [redacted].

During the period from FYE [redacted] through [redacted], [redacted] was current on all other payable accounts.

Forms 5472

On Forms 5472, which were attached to Forms 1120, [redacted] reported its monetary transactions with [redacted] as follows:

	[redacted]	[redacted]	[redacted]	[redacted]
Amounts borrowed ending balance (Part IV, line 7b)	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Rents and royalties paid (Part IV, line 14)	$[redacted]	$[redacted]	$[redacted]	$[redacted]
interest paid (Part IV. line 19)	$[redacted]	$[redacted]	$[redacted]	$[redacted]

During the audit, [redacted] amended Forms 5472 for FYE [redacted] and FYE [redacted] to show the loans from [redacted], and the interest and royalties that it deducted on the returns.

FORMS 1042[14]

For [redacted] and [redacted], [redacted] neither filed Forms 1042 nor paid any withholding taxes.

---

[14] The Service requires that the Form 1042 be filed annually on a calendar year basis. Treas. Reg. § 1.1461-2(b).

For [redacted] and [redacted], [redacted] did not file Forms 1042. [redacted], however, made tax deposits totaling [redacted]% of the withholding taxes due on the interest accrued in FYE [redacted] and [redacted], and on the royalties accrued in [redacted]. For unknown reasons, the Service returned those deposits.

For [redacted], [redacted] filed a Form 1042, and deposited [redacted]% of the withholding taxes due on the interest and royalties accrued in FYE [redacted].

DISCUSSION

I. Interest Imputation.

In the case of below-market or no interest loans between a corporation and its shareholder, I.R.C. §§ 482 and 7872 are the two sections that could apply to impute interest income to the lender. I.R.C. 7872, however, exempts certain below-market loans from its application. Specifically, Treas. Reg. § 1.7872-5T(b)(10) exempts from I.R.C. § 7872 loans made to or from a foreign person that meet the requirements of Treas. Reg. § 1.7872-5T(c)(2). That regulation provides that § 7872 shall not apply to a below-market loan if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender would be effectively connected with the conduct of a U.S. trade or business within the meaning of I.R.C. § 864(c) and the regulations thereunder.

Here, because [redacted] had no U.S. trade or business to which the interest income would be effectively connected, § 7872 would not apply in this case to impute interest. However, regardless of whether interest can be imputed under § 7872, interest can be imputed on certain loans that do not bear interest at the market rate under I.R.C. § 482.

A. I.R.C. § 482.

I.R.C. § 482(a) authorizes the Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between controlled entities, if it determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to clearly reflect the income of any of such controlled entities.[15] The purpose of I.R.C. § 482 is to prevent

---

[15] I.R.C. § 482 provides, in pertinent part, as follows:

> In any case of two or more organizations, trades, or business (whether or not incorporated, whether or not organized in the

the artificial shifting of the true net income of controlled taxpayers by placing such taxpayers on a parity with an uncontrolled, unrelated taxpayer. See Treas. Reg. § 1.482-1(b)(1); Commissioner v. First Security Bank, 405 U.S. 394, 400 (1972); Bausch & Lomb. Inc. v. Commissioner, 92 T.C. 525 (1984), aff'd, 933 F.2d 1084 (2d Cir. 1991); Sundstrand Corp. v. Commissioner, 96 T.C. 226 (1991); BForman Company v. Commissioner, 453 F.2d 1144 (2d Cir. 1972).

B. Imputing interest to [redacted] for the periods in which the interest was waived.

You propose to impute interest to [redacted] under I.R.C. § 482 for the periods in which the interest was waived.

In this case, whether the Service may impute interest to [redacted] depends on whether an unrelated creditor dealing at arm's length with [redacted] would have imposed interest during the waiver periods. See Treas. Reg. § 1.482-1(b)(1); Oil Base, Inc. v. Commissioner, 362 F.2d 212, 214 (9th Cir. 1966), cert. denied, 385 U.S. 928 (1966); B. Forman Company, Inc. v. Commissioner, 453 F.2d 1144, 1155 (2d Cir. 1972). This, in turn, depends largely on [redacted] ability to pay. If [redacted] was financially distressed for reasons not attributable to any non-arm's length transactions, and [redacted] had no reasonable expectation of collecting the interest, imputation may not be appropriate. See Procacci v. Commissioner, 94 T.C. 397 (1990); Johnson v. Commissioner, T.C. Memo. 1982-517, aff'd without opinion, 729 F.2d 1447 (3d Cir. 1984); Newhouse v.Commissioner, 59 T.C. 783, 786-87 (1973).

[redacted] claims that the interest waiver was due to its inability to pay. We find this claim unpersuasive. In each year from FYE [redacted] through FYE [redacted], [redacted] reported positive taxable income (before net operating loss deductions). In each of the aforementioned years, [redacted] assets also exceed its liabilities

---

United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

(excluding shareholder loans). [redacted] was clearly solvent during the waiver periods.

Moreover, [redacted] had ample funds to pay the interest. As Chart A shows, in the half-year period from January [redacted] to June [redacted] alone, [redacted] repaid more than $ [redacted] dollars of the principal. In FYE [redacted], the principal was reduced by $ [redacted] dollars (without counting the debt-equity conversion); that amount rose to $ [redacted] dollars in FYE [redacted]. These principal repayments certainly were large enough to cover the interest payments. Based on [redacted] financial condition and payment history, an unrelated creditor dealing at arm's length with [redacted] would have expected to collect interest payments,[16] and would have exercised its right under the notes and applied the principal repayments to interest first. We thus believe imputing interest to [redacted] for the waiver periods is appropriate.

C. Interest rate to be imputed.

The Service may make appropriate allocations to reflect an arm's length rate of interest for the use of funds, where one member of a controlled group makes an interest-free loan or a loan at less than an arm's length rate of interest to another member of the group. Treas. Reg. § 1.482-2(a)(1)(i). The term "arm's length rate of interest" means a rate of interest which was charged, or would have been charged, by an unrelated party under similar circumstances at the time the indebtedness arose. Treas. Reg. § 1.482-2(a)(2). Generally, the period for which interest is charged begins on the day after the indebtedness arises and ends on the day that the indebtedness is satisfied. Treas. Reg. § 1.482-2(a)(1)(iii)(A).

Treas. Reg. § 1.482-2(a)(2) provides safe haven interest rates[17] for the purposes of determining whether a rate is an arm's length rate. Treas. Reg. § 1.482-2(a)(2)(iii)(A)(ii). The safe haven interest rates range from 100 percent (lower limit) to 130 percent (upper limit) of the applicable Federal rate. Treas. Reg. § 1.482-2(a)(2)(iii)(B). If no interest is charged, then an arm's length rate shall equal the lower limit compounded semiannually. Treas. Reg. § 1.482-2(a)(iii)(B)(2).

---

[16] An unrelated third party that was not collecting interest on the outstanding indebtedness would not have continued making loans to [redacted].

[17] The safe haven interest rates apply to any interest paid or accrued after May 8, 1986 under a demand loan or advance between controlled entities. Treas. Reg. § 1.482-2(a)(2)(iii)(A)(1)(i).

Following the above guidelines, the Service may impute interest to [redacted] for the waiver periods at the stated of rate of [redacted]%, provided this rate meets the arm's length standard under Treas. Reg. § 1.482-2(a)(2). If the stated rate does not meet the arm's length standard, then the Service may use the lower limit of the safe haven rates to impute interest. You may need to determine when each loan arose in order to calculate the amount of the imputed interest.

D. Imputing additional interest.

You believe that the rates stated in the Notes were below-market because they were below the lower limit of the safe haven rates and propose to impute additional interest for FYE [redacted] through [redacted] under I.R.C. § 482.

According to Treas. Reg. § 1.482-2(a)(2)(iii), if an interest rate falls below the lower limit but exceeds the rate determined under Treas. Reg. § 1.482-2(a)(2)(i), it will be considered as an arm's length rate. See Treas. Reg. § 1.482-2(a)(2)(iii)(B)(3). In other words, an interest rate does not become a below-market rate merely because it falls below the lower limit of the safe haven interest rates. As long as that rate is an arm's length rate under Treas. Reg. § 1.482-2(a)(2)(i), it will be respected and no I.R.C. § 482 adjustment is warranted.

II. Withholding Tax Consequences.

A. Withholding under the Code & treaty.

Generally, a foreign corporation is subject to a [redacted]% tax on any U.S. source fixed or determinable, annual or periodical payments ("FDAP"), such as interest and royalties, if those payments are not effectively connected with the conduct of a U.S. trade or business. I.R.C. § 881. The withholding rate may be reduced by treaty. Treas. Reg. § 1.1441-6(a). In this case, [redacted] would be entitled to the benefits of the Treaty and a reduced withholding rate of [redacted]% for interest and royalties. See Articles 11, 12 of the Treaty.

The mechanism for collecting the tax imposed by I.R.C. § 881 is provided in I.R.C. §§ 1441 and 1442. I.R.C. § 1442 provides that, in the case of foreign corporations, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in I.R.C. § 1441 a tax equal to 30% thereof. I.R.C. § 1441 imposes the withholding obligation on the payor of the income subject to withholding. Treas. Reg. §§ 1.1441-2(a)(1), (b)(2)(iii). The payor liable for deducting and withholding such tax is indemnified against the claims and demands

of any person for the amount of any payments made in accordance with I.R.C. §§ 1441 and 1442. See I.R.C. § 1461.

B. [redacted] withholding tax liabilities.

(1) Interest imputed under I.R.C. § 482.

[redacted] argues that even if the Service may impute interest under I.R.C. § 482, it should not be held liable for any withholding taxes because there were no actual payments to trigger the withholding of tax under I.R.C. § 1442.

The precise issue of whether an I.R.C. § 482 allocation of U.S. source FDAP to a foreign entity is subject to I.R.C. § 1442 withholding has not been addressed by any court. There is, however, case law supporting such an approach. See Climaco and Nakamura v. Internal Revenue Service, 96-1 USTC ¶ 50,153 (E.D.N.Y. 1996)(unpublished opinion, January 24, 1996); Casa De La Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990); Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994).

In Climaco and Nakamura, the District Court held that the plaintiffs were required to withhold and pay a portion of the interest imputed pursuant to I.R.C. § 7872 even though they did not actually make any interest payments on the loan.

In Casa De La Jolla Park, Inc., the Tax Court rejected petitioner's argument that I.R.C. § 1441 requires actual payment and receipt, noting that "payment" is merely one of several terms (control, receipt, custody, etc.) that are described in I.R.C. § 1441(a) in the disjunctive. Supra, at 393.

In Central de Gas de Chihuahua, the Tax Court held that I.R.C. § 881 does not require actual payment of the income item and that the allocation of income pursuant to I.R.C. 482 provides a sufficient basis for imposing the tax under I.R.C. § 881. Following this logic, income imputed under § 482 should be subject to the withholding liability under I.R.C. §§ 1441 and 1442 since §§ 1441 and 1442 are the means to collect the § 881 taxes. To separate the § 881 tax liability from its collection mechanism would render the operation of § 881 ineffective. The Tax Court touched this concern when it observed that "[a] holding that actual payment is required could significantly undermine the effectiveness of section 482 where foreign corporations are involved. Such a view would permit such corporations to utilize property in the United States without payment for such use and thereby avoid any liability under section 881." Supra, at 520.

Additionally, a recently-issued final regulation specifically provides that an allocation of income subject to withholding under

§ 482 is subject to withholding under § 1441. See Treas. Reg. § 1.1441-2(e)(2). While this regulation did not take effect until the year 2001 (and hence does not apply to the tax years involved in this case), it does represent a position consistent with current law on this point.[18]

(2) Debt-equity conversion.

(i) Withholding taxes.

On [redacted], [redacted] converted $ [redacted] of the loans into [redacted] shares of preferred stock in [redacted]. We believe under Fender Sales, Inc. v. Commissioner, 338 F.2d 924 (9th Cir. 1964), rev'g T.C. Memo. 1963-119, this transaction may be characterized as a $ [redacted] debt repayment by [redacted] followed by [redacted] contribution of $ [redacted] in exchange for the stock.

In Fender Sales, Inc., a corporation was indebted to its two shareholders for accrued but unpaid salaries. The corporation discharged the debt by issuing additional shares of stock to the shareholders. The Ninth Circuit found that the transaction constituted a salary payment to those individuals.[19]

Similarly, in this case, [redacted] discharged $ [redacted] of debt by issuing additional stock to [redacted]. In the Ninth Circuit's view, this debt-equity conversion constitutes a constructive debt repayment to [redacted]. Consequently, a portion of the amount converted should be treated as an interest payment. See Treas. Reg. § 1.446-2 ("[E]ach payment under a loan . . . is treated as a payment of interest to the extent of the accrued and unpaid interest."); see also Estate of Ratliff v. Commissioner, 101 T.C. 276 (1993). If a portion of the payment is treated as an interest payment, such portion is subject to withholding under I.R.C. §§ 1441 and 1442.[20]

---

[18] Moreover, neither the preamble to the regulation nor the regulation itself indicates that the regulation was intended to reflect a change in the Service's position.

[19] The Tax Court questioned and refused to follow the Ninth Circuit's view in Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), aff'd, 601 F.2d 734 (5th Cir. 1979). Nonetheless, we believe that Putoma Corp. would not preclude the successful application of a Fender Sales theory here, because the Golsen rule would compel the Tax Court to follow the Ninth Circuit holding in Fender Sales. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

[20] Unlike the interest imputed under § 482 where no case law directly addresses whether withholding applies, the interest

(ii) Cancellation of indebtedness income.

You ask whether [redacted] realized COD income under I.R.C. § 108(e)(8) when it issued the preferred stock to satisfy the $ [redacted] of debt owed to [redacted].

Under I.R.C. § 108(e)(8), a corporation that issues its own stock to a creditor in satisfaction of outstanding debt realizes income from discharge of indebtedness to the extent that the principal of the debt exceeds the value of the stock.

We do not know the fair market value of the stock in question; we therefore are unable to opine whether [redacted] realized any C.O.D. income.

(3) Interest and royalties that were deducted.

I.R.C. § 267(a)(3) puts [redacted] on a cash basis with respect to the interest owed to [redacted], so that even if the interest was accrued for accounting purposes, no tax deduction for the interest would be allowed prior to its actual, constructive, or deemed payment. By deducting the interest accrued under the Notes, [redacted] implicitly acknowledged that the interest due was paid and should therefore be subject to the withholding liability under § I.R.C. § 1442.

The royalties deducted by [redacted] in the FYE [redacted] and [redacted] returns are also subject to withholding under § I.R.C. § 1442. Crediting those royalties to the Loan Account is equivalent to paying the royalties with money borrowed from [redacted]. There were clearly "payments" to trigger withholding.

III. Rents.

During FYE [redacted] through [redacted], [redacted] paid[21] rents to [redacted]. Since rent is an item of income specified in I.R.C. § 1441(b), [redacted] had a duty to withhold [redacted]% tax under I.R.C. § 1441(a), unless the rents are treated as ECI. I.R.C. § 1441(c)(1).

A. Rents as ECI.

I.R.C. § 882(d)(1) provides that a foreign corporation receiving rental income from real property located in the U.S. in any taxable year may elect to treat all such income as ECI

---

here is a constructive payment of interest that is clearly subject to § 1442 withholding.

[21] Crediting the rents to the Payable Account is equivalent to paying the rents with money borrowed from [redacted].

regardless of whether it engages in a trade or business within the United States. I.R.C. § 882(d)(1). Article 6 of the Treaty also provides that rental income may be taxed by the country in which such real property is situated. A corporation desiring to invoke the benefit of I.R.C. § 882(d)(1) may make the said election in accordance with the manner set forth in Treas. Reg. § 1.871-10. Treas. Reg. § 1.882-2(a). In that case, the foreign corporation shall be taxed as a domestic corporation on the rental income and may claim associated deductions and credits. I.R.C. §§ 882(d), 882(c)(1)(A).

In order for a foreign corporation to claim the deductions and credits relating to the rental income, the corporation must file a true and accurate return in the manner prescribed in Subtitle F. I.R.C. § 882(c)(2). The return must include all the information which the Secretary may deem necessary for the calculation of such deductions or credits. Id. Moreover, the return must be filed within the time limits set forth in Treas. Reg. § 1.882-4(a)(3)(i). Treas. Reg. §§ 1.882-4(a)(2)and (a)(3). Alternatively, a foreign corporation may file a "protective return" if the corporation conducts limited activities in the United States in a taxable year which the foreign corporation determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States. Treas. Reg. § 1.882-4(a)(3)(iv). By filing this protective return, the foreign corporation protects its right to receive the benefit of allowable deductions and credits, and avoids any potential disallowance of deductions and credits that may arise by virtue of I.R.C. § 882(c)(2), if it is later determined that the corporation's original determination was incorrect. Id. A protective return must also be filed within the time limits set forth in Treas. Reg. § 1.882-4(a)(3)(i). Id. The filing deadlines set forth in Treas. Reg. § 1.882-4(a)(3)(i) may be waived only in rare and unusual circumstances when good cause for such waiver is established by the foreign corporation. Treas. Reg. § 1.882-4(a)(3)(ii).

Here, [redacted] has filed protective Forms 1120-F for FYE [redacted] and [redacted] to protect its right to report the rental income as ECI. Assuming the protective Forms 1120-F were filed timely, and valid elections under I.R.C. § 882(d) were made, [redacted] may report the rental income as ECI and claim associated expenses and credits.

B. Rents subject to withholding.

As to FYE [redacted], [redacted], and [redacted], since no Forms 1120-F were filed, the rents would be subject to the § 881 withholding tax and [redacted] would be liable for withholding [redacted]% of taxes on the rents under I.R.C. § 1442.

III. Penalties.

You propose to assert three penalties against [redacted]: (1) the § 6656(a) penalty for failure to make withholding tax deposits[22] for FYE [redacted] through [redacted]; (2) the § 6651(a)(1) penalty for failure to file Forms 1042 for FYE [redacted] through [redacted];[23] and (3) the § 6038A(d) penalty for filing substantially incomplete Forms 5472 for FYE [redacted] and [redacted].

A. Failure to make Federal tax deposits and file Forms 1042.

I.R.C. § 1463 provides that if a withholding agent fails to deduct and withhold tax as required, he will be subject to any applicable penalties or additions to the tax as a result of such failure to deduct and withhold.

I.R.C. § 6651(a) imposes a penalty for failure to file an income tax return, unless it is shown that such failure is due to reasonable cause and not to willful neglect. Form 1042 is an income tax return. Northern Indiana Public Service Co. v. Commissioner, 101 T.C. 656 (1994). The penalty for not filing Form 1042 when due is usually 5% of the unpaid taxes for each month the return is late, but not more than 25% of the unpaid taxes. I.R.C. § 6651(a).

I.R.C. § 6656(a) imposes a penalty for failure to make deposit of tax with the same exception for reasonable cause. The penalty is calculated based on a percentage of the underpayment of taxes, as follows: 2% if the deposit is 1 to 5 days late; 5% if the deposit is 6 to 15 days late; or 10% if the deposit is 16 or more days late. I.R.C. § 6656(b)(1).

For [redacted] and [redacted], [redacted] failed to file Forms 1042 or to make withholding tax deposits. We recognize that there are three withholding taxes applicable to these two years: the [redacted]% withholding tax on the rents; the [redacted]% withholding tax on the

---

[22] A withholding agent must periodically make a tax deposit for the tax withheld in each calendar year. The amount of tax withheld determines the frequency of the deposits. If the withholding agent fails to timely make a required deposit, he may be subject to a penalty on the underpayment. See Publication 515.

[23] Every withholding agent must file an annual return on Form 1042 by March 15 of the year following the end of a calendar. A penalty for not filing Form 1042 when due is usually assessed based on a percentage of the unpaid tax for each month the return is late. See Publication 515.

interest imputed under I.R.C. § 482; and the [redacted]% withholding tax on the constructive interest payment arising from the debt-equity conversion. We recommend that you inquire whether any reasonable cause exists that may enable [redacted] to avoid the §§ 6656 and 6651(a) penalties. For example, you may ask whether [redacted] was aware of the withholding statutes, whether [redacted] had concerns that the interest waiver could be subject to § 482 adjustments, and whether [redacted] sought and relied on the tax advice of qualified professionals. In essence, you need to determine whether [redacted] took any steps to comply with the tax law and whether those steps were reasonable.

For [redacted] and [redacted], we recommend that you develop additional facts as to why the Service refunded [redacted] tax deposits. The Service's unexplained actions might have reasonably led [redacted] to believe that no filing was necessary.

B. Failure to accurately file Forms 5472.

(1) The I.R.C. § 6038A reporting requirements.

I.R.C. § 6038A requires a foreign-owed domestic corporation such as [redacted] to file an annual information return on Forms 5472 with respect to any reportable transactions that it had with its foreign parent. Treas. Reg. § 1.6038A-2(a)(1). "Reportable transactions" basically consist of two types: transactions for which only monetary consideration is paid or received by the domestic reporting corporation; and transactions involving non-monetary consideration or less than full consideration. See Treas. Reg. §§ 1.6038A-2(b)(3), (b)(4). Examples for transactions involving solely monetary consideration include rents, royalties, and interest paid and received, and loans made and borrowed, by the reporting corporation. Treas. Reg. § 1.6038A-2(b)(3).

A reporting corporation failing to file a Form 5472 will be subject to a $ 10,000.00 penalty for each taxable year with respect to which such failure occurs. I.R.C. § 6038A(d)(1). If the taxpayer continues to fail to comply with the reporting requirements under I.R.C. § 6038A for more than 90 days after notification of failure to comply is mailed to the taxpayer, then in addition to the initial $ 10,000.00 penalty, the taxpayer must pay an additional $ 10,000.00 penalty for each additional 30 days in which it is in noncompliance. I.R.C. § 6038A(d)(2).

Filing a "substantially incomplete" Form 5472 constitutes a failure to file Form 5472. Treas. Reg. § 1.6038A-4(a)(1). The penalty may be waived if reasonable cause exists. Whether a taxpayer acted with reasonable cause will be determined on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6038A-4(b)(2)(iii).

Neither the regulations nor the case law defines the term "substantially incomplete." Given that the Forms 5472 initially filed by [redacted] for FYE [redacted] and FYE [redacted] lacked many reportable transactions such as the loans from [redacted], and the royalties, rents, and interest that were deducted, most likely they will be considered as "substantially incomplete." Nevertheless, we recommend that you obtain additional facts to support such a determination. We also recommend that you ask [redacted] why it omitted the foregoing transactions on the Forms 5472 and evaluate the reasonableness of its explanations before asserting the §6038A(d)(1) penalty.

Moreover, we note that I.R.C. § 6501(c)(8) may apply to FYE [redacted]. § 6501(c)(8) provides, in pertinent part,[24] that where a taxpayer is required to report any information under § 6038A, the time for assessing any tax against that taxpayer for the period to which such information relates shall not expire until 3 years after the date on which the Service is furnished the required information. If § 6501(c)(8) applies, FYE [redacted] will still be open to adjustments. If you wish to pursue this issue, please contact this office immediately.

This advice has been coordinated with the International branch of the National Office using the pre-review procedure. Please contact Erica Wu at (949) 360-2678 if you have any questions.

---

[24] Information subject to I.R.C. § 6501(c)(8) includes the information required to be reported under §§ 6038, 6038A, 6038B, 6046, 6046A, and 6048. § 6501(c)(8) is effective for information with a reporting due date after August 5, 1997.